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"In order to form an opinion on the policy of deflation and liquidation, it must first be recognized that every depression is a depression of profits occasioned by the fact that the price curve and the cost curve cut."

Wilhelm Ropke, *Crises and Cycles*, p. 180
W. Hodge & Co. London, 1936

HIGHLIGHTS

Trends in U.S. credit and money haven't been so anaemic and unsupportive ever before in the entire post-war period. These figures reveal an extremely inhospitable monetary environment that's still deteriorating.

The collapse of U.S. money growth is not a statistical freak. It's a fundamental reality because the bleak money numbers dovetail perfectly with equally drab credit statistics. The obvious driving force of the money contraction is a spreading credit crunch both inside and outside the banking system.

What the whopping contradictions in the indicators of Fed policy and the monetary aggregates reflect is a vast gap between what the Fed intends and what it has achieved. No matter what the best intentions of the Fed may be, the fact is that monetary conditions are punishingly restrictive.

So far, in 1991, loan expansion has been dead-zero. The commercial banks, too, along with the S&L's, are out of the loan business and now insurance companies add to the financial troubles. On balance, only investments in government securities have increased.

Irving Fisher's famous "debt deflation theory" is manifesting itself in the nation-wide collapse of real-estate values and is crushing capital across the whole financial system. There's little doubt: this is a massive credit contraction.

A little more easing will hardly alleviate the pressure of the meltdown in the value of real estate collateral on the U.S. financial system. Policy-makers, creditors and debtors are keeping their fingers crossed in the hope that these values will miraculously recover.

The corporate sector's long-running profit squeeze was a major factor that drove the U.S. economy into recession. Any potential for recovery crucially depends on the health and strength of corporations. They are the key, not the consumer.

It's one of the many Wall Street myths that foreign capital is being drawn into the United States by unusually high levels of profitability. It's a mockery of reality.

A deepening U.S. recession will compel a desperate Fed to ease monetary policy even more. That action when it unfolds will claim two main victims: the U.S. stock market and the U.S. dollar. Both can be expected to plunge.

NO CREDIT, NO MONEY, NO RECOVERY

Confusion is back. No sooner had economists and policy-makers reached near-unanimity in declaring the happy message that the U.S. recession was over, than did the latest batch of economic and monetary data again rain on the parade. As might be guessed, though, the expected recovery has only been pushed out to yet another rain-date. Inexplicably, this deep-seated optimism — demonstrated no less by Fed forecasts of an imminent recovery — stubbornly ignores one of the blackest clouds on the horizon in memory: persistent and chronic weakness in the money and credit numbers. If there's one inviolate economic law, it's that recoveries need money. Yet, all kinds of theories abound arguing that slow money growth presents little or no risk to an expected recovery.

Even more out of "sync" are Wall Street's persistent ravings about a liquidity-driven bull market due to the fact that money growth exceeds nominal GNP growth. The clever theory goes that the surplus of money not needed for transactions in real commerce instead flows into financial assets and propels their prices higher. That's why Wall Street tends to party when the economy weakens.

While the fantasy effects of "excess" liquidity on the stock market appears nicely plausible, reality is strikingly different. Actually, the exact opposite is happening. Ever since early 1987, money growth has been running well below GNP growth and in the meanwhile has cumulated into an unprecedented shortfall of money supply. The contrast of the present period to the earlier 1980s is no less than overwhelming as the figures in the table below show. (We have picked M2 for our illustration because that's the monetary aggregate which Fed policy deliberations tends to focus upon).

What these figures clearly show for the last year is a cumulative shortfall of money relative to GNP — not the excess money machine that Wall Street is so delirious about. How is it then that stock prices recovered from the lows of the October 1987 crash and that the U.S. economy continued to grow despite money growth persistently trailing GNP growth?

COURTESY OF FOREIGN CENTRAL BANKS

How did the U.S. economy rebound so smartly in 1988-90 despite anaemic money growth? Through two channels thanks to the courtesy of foreign central banks and investors and foreign stimulated demand. These forces delivered the needed stimulus and liquidity which more than offset the internal monetary restraint within the U.S.. For the first time ever, America enjoyed an export-led expansion.

COMPARATIVE U.S. GNP AND MONEY
(Annual % Change)

	<u>GNP</u> <u>GROWTH</u>	<u>MONEY</u> <u>GROWTH(M2)</u>	<u>GAP</u>
1981	8.9	10.0	1.1
1982	3.7	8.9	5.2
1983	7.6	12.0	4.6
1984	10.8	8.6	-2.2
1985	6.4	8.2	1.8
1986	5.4	9.4	4.0
1987	6.7	3.5	-3.2
1988	7.9	5.5	-2.4
1989	6.7	5.0	-1.7
1990	5.1	3.3	-1.8
1991*	3.4	2.2	-1.2

* Annualized figures for the first half of 1991 preliminary.

Almost 50% of U.S. GNP growth between 1987 and 1990 can be directly attributed to surging U.S. exports. In short, the strong pull of exports propping up the U.S. economy allowed the Fed to take a back seat.

But what about the bullish stock market? Isn't it proof of the existing excess liquidity that most Wall Street pundits like to assert? Unfortunately, it proves nothing of the kind. The simple explanation is that it requires very little cash to drive a stock market higher compared with the vast stream of money that are needed to buoy GNP. That's more true than ever in today's markets which are influenced by highly-leveraged, derivative-product trading.

A FUNDAMENTALLY NEW SITUATION FOR THE FED

In any case, the Fed is now facing a fundamentally new situation. Flagging economic activity in many of the United States' major trading partners has derailed the American export locomotive. This shift is significant. It essentially implies that the task of restimulating the U.S. economy out of recession is back on the shoulders of Mr. Greenspan and the Fed. As the export stimulus fades, internal money and credit growth again assumes overriding and critical importance.

Wall Street — looking at ample bank reserves, extremely low short-term interest rates and a steep yield curve — is hyped by the notion that the Fed's money stance is extremely easy and therefore, like always, guarantees a continued bull market in stock and bonds and an economic recovery. Others, like ourselves, have our eyes glued on past and current trends in credit and money growth.

Undoubtedly, trends in credit and money haven't been so anaemic and unsupportive ever before in the whole post-war period. Statistics point to the conclusion that monetary conditions are now punishingly restrictive — not extremely easy — irrespective of what Fed policy may intend.

What these whopping contradictions in the monetary indicators indeed reflect is a vast gap between what the Fed intends and what it has achieved. To be sure, the Fed has eased aggressively. Yet, the crucial point is that it has failed miserably to infuse any life into the monetary and credit system. What's worse, despite one easing move after another, the credit and money figures signal a progressively deteriorating situation on the money side. Were it not for the rising budget deficit, U.S. money supply would be collapsing.

FRIGHTENING MONEY NUMBERS

While some wilful believers in the U.S. recovery are beginning to admit some perplexity — if not a bit worry — in response to the plunging money-supply growth, others still shrug off the phenomenon and explain it away as some insignificant technicality.

Beware! The collapse of money growth is not a statistical freak. It's a fundamental reality because the bleak money numbers dovetail perfectly with credit numbers that are just as drab. The obvious driving force of the money contraction is a spreading and intensifying credit crunch, both inside and outside the banking system.

The broader monetary aggregates have virtually disintegrated. Two of them, M3 and M4, are

experiencing negative growth for the first time ever in the post-war period . . . and that's before adjusting for inflation! M4 (or L), worst of all, has plummeted at an annual rate of 5% during the past three months and M3 has sagged at a rate of 1.5% since the end of March. Taken over the past twelve months, M4 has increased only \$40 billion or 0.8%. That can only be seen as a sharp down-shift when viewed in the context of the more usual rises of about \$300 billion per annum over previous years. M2 growth, while still positive, has slowed down to a meagre rate of 1% since the end of March 1991. Not only do these figures reveal an extremely inhospitable monetary environment, it's even worse since these numbers continue to deteriorate.

Confirming our concern, something else is hitting new post-war lows. That is private credit growth, which includes both business and consumer loans. Over the past year, private credit expansion has slowed to 3.9% and by all accounts is still slowing.

There is one striking exception to this dominating monetary sluggishness which we've described. The narrow money stock, M1, shows persistent buoyancy, having expanded at an annual rate of 8% over the past six months. Understandably, Wall Street "bulls" are taken in by the strong M1.

STRONG M1 VERSUS COLLAPSING M3 AND M4

What is more relevant for the economy, buoyant M1 or the sliding broader money and credit aggregates? Our answer, undoubtedly, is the latter. Why? Because the broader aggregates are overwhelmingly and inextricably connected with spending on goods and services while M1 is more strongly correlated to financial activity.

The trade of a financial asset obviously requires the same quantity of money as the purchase and sale of an equal volume of national product. Considering the feverish activity on Wall Street, it's easy to see why M1 is out of tune with the other aggregates and the broader economy. The only conclusion we draw from higher M1 growth is that Wall Street is out of tune with the economy.

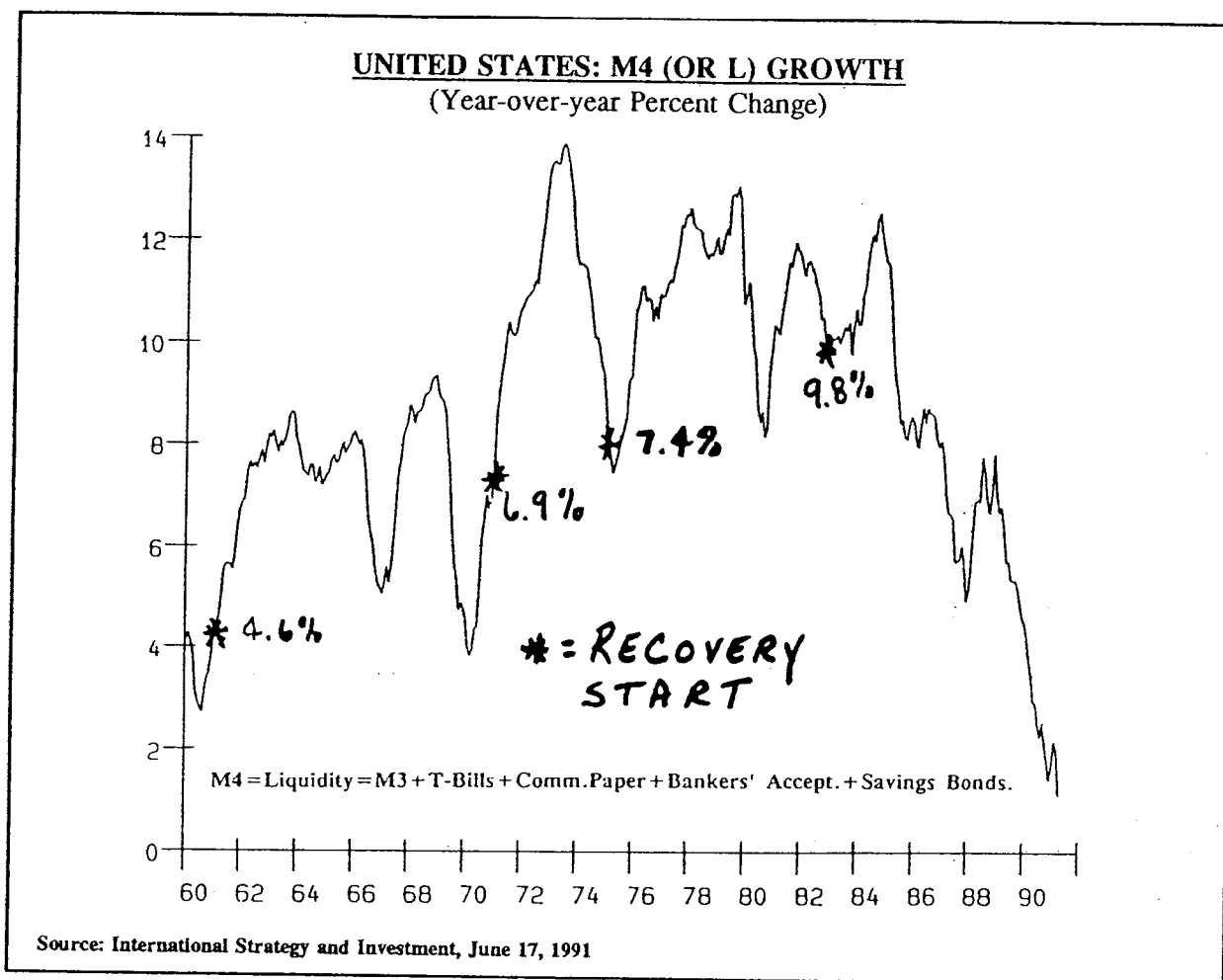
To this point, complete credit figures are only available to the end of the first quarter of 1991. The recent collapse of the broader aggregates, though, parallels a worsening trend since then.

CREDIT EXPANSION OF U.S. NON-BANK FINANCIAL INSTITUTIONS (In \$U.S. billions)

<u>1983</u>	<u>1984</u>	<u>1985</u>	<u>1986</u>	<u>1987</u>
350	504	527	656	434
<u>1988</u>	<u>1989</u>	<u>1990</u>	<u>1991</u>	
443	383	304	91*	

* Annual rate 1Q 1991, Flow of Funds Account
Federal Reserve

The adjacent table, by the way, also answers the question of why the broad money and credit aggregates are so particularly weak now after years of over-proportionate strength. It's mainly a reflection of trends in lending outside the banking system. As non-bank lending surged during past years, broader aggregates were boosted. Now, as this lending plunges, it depresses the broad money and credit aggregates.



IF PAST IS PROLOGUE, MONEY MATTERS

We repeat our question: How is it possible to have a sustained U.S. economic recovery with such forbidding money and credit numbers? Current trends suggest a degree of monetary stringency that has no parallel during the entire post-war period. As the chart above illustrates, M4 grew at an average rate of 7.0% at the beginning of previous recoveries. The present M4 growth pace of 0.8% couldn't compare more dismally. And what's more, to repeat ourselves again, the monetary contraction still seems to be gathering force.

What astonishes us even more than the exceptionally weak monetary facts is the near-total silence on this subject by Wall Street analysts. While analysts can elaborate endlessly on every statistical blip, they are steering a wide arc around this issue of most critical importance. It's a topical taboo. Any conclusion falling out of any monetary analysis, of course, would fly in the face of the rosy story of "excess liquidity" fuelling the stock market boom. More probably, many analysts simply lack the theoretical underpinning to understand the causal mechanism behind this squeeze. Most monetarists know everything about money supply except how it is created and destroyed. If they did, they would take a more careful look at the role of credit.

For us, it's not a question of whether or not the Fed should come to the rescue but rather whether the Fed still has the power to throw a floating life preserver. Who's kidding who? A little more easing will hardly alleviate the pressure of the meltdown in the value of real estate collateral on the U.S. financial system.

Policy-makers, creditors and debtors are keeping their fingers crossed in the hope that these values will miraculously recover. They fully realize that a permanent, if not progressive, decline in real estate values could conceivably create an Armageddon scenario. Yet, exactly that progressive decline is what the plunging money numbers are mirroring.

It seems one cannot emphasize enough the fact that the ongoing money and credit crunch is fundamentally different from anything that has gone before. Firstly, the credit squeeze is unusually prolonged and severe. Secondly, and more importantly, the crunch is clearly not the result of a deliberate tightening of monetary policy. Contrarily, monetary policy has been eased aggressively as measured by the decline in the Fed funds rate and the rise in excess bank reserves. Never before has there been a recession preceded by such a prolonged monetary easing — not in all of modern history.

FROM THE S&L DISASTER . . .

The top question remains: Where is the origin of this credit and money squeeze that's spreading and still growing in severity? Is it a function of credit supply or waning credit demand?

Most probably it's a vicious circle that reinforces itself from both sides of the credit equation as lenders and borrowers mutually strive to reliquify their balance sheets by selling assets (at falling prices) and curtailing expenditures. Irving Fisher's famous "debt deflation theory" is manifesting itself in the nation-wide collapse of real-estate values and is crushing capital across the whole financial system. The sober reality is that the past credit boom was excessively based on the collateral of commercial real estate values.

As the American financial system's weakest link, savings and loans associations (S&L's) were only the first visible casualty of these lending excesses. Yet the staggering costs of the S&L bailout by the federal government are only part — surely the smaller part — of the total costs. Far more ominous are the potentially open-ended costs of a crippled financial system to the nation and the economy as a whole. The Resolution Trust Corporation (RTC) has over \$300 in real estate for sale. Trying to unload it spreads the savage deflation in the commercial real estate market and its destructive impact on capital right across the whole financial system. In addition, there's a backlog of another \$300 billion in banks and S&L's which have not been taken over simply because there's no money available from either the RTC or the Federal Depositary Insurance Corporation (FDIC).

From a general monetary and economic point of view, the most crucial and immediate effect of the S&L crisis is the massive contraction of financial assets and deposit that it triggers. Since the end of 1988, S&L assets have fallen from \$1.35 trillion to \$1.05 trillion (ending February 1991). Month after month, an average of \$10 to 20 billion pour out of the S&L's. How long can the contraction continue? One might do well to remember that the boom in S & L assets during the 1980s grew from a base of only \$560 billion.

... TO THE BANKING MESS

While the S&L's are being dismembered, the commercial banks — collectively the key engine of the credit system with total assets of \$2.75 trillion — have also come to a virtual lending halt for the first time in almost six decades. Compare these numbers: Banks expanded their loans by \$145 billion in 1988, \$162.5 billion in 1989, and by \$76.6 billion in 1990. So far in 1991, loan expansion has been dead-zero. The commercial banks, too, along with the S&L's are out of the loan business. On balance, only investments in government securities have increased.

While it is often stressed that the commercial banks are in much better shape than the S & L's, the comparison really conceals more than it reveals. The American banking system is at its shakiest since the 1930s. Many banks, fighting for survival, are squeezing the availability of credit. The bad loans of the past years are now coming home to roost. The problem is that the recession itself, by causing more and more loan losses, creates more and more troubled banks that in turn are curtailing credit further and further.

The FDIC has a list — which isn't publicly available, by the way — of "problem" banks that it regards as being particularly vulnerable to failure. At the end of 1990, there were 1048 banks on this list representing \$408 billion in assets. According to competent private estimates, there actually are some \$750 billion of assets in the hands of troubled banks.

Bank problem-loans are concentrated in three credit categories: loans to developing countries not yet written off (about \$60 billion); highly leveraged loans to commercial corporations (about \$190 billion); and commercial real estate (about \$400 billion).

... TO THE INSURANCE CRISIS

Following the S&L's and the commercial banks, a third big group of lenders is now fanning public anxiety. Life insurance companies are starting to wobble. This group accounts for total assets of around \$1.4 trillion, having grown explosively from a level of \$479 billion in total assets at the start of the 1980s. The formerly staid and highly conservative insurance industry, too, turned into a rocketing "go-go." In a rush to compete with the fast-evolving financial investment markets, life insurers spread their nets wider and wider with new "hybrid" products.

Now, insurance companies are trapped in the same predicament as the S&L's and the banks. Offering their customers sharply higher returns, they had to channel more of their funds into higher-risk and therefore higher-yielding assets. Guaranteed investment contracts (GIC's) — promises to pay fixed returns over periods as long as 10 years — were sold by the billions to pension funds for which the policyholders plunked down a one-time fixed sum. That's normal enough for the insurance business. What wasn't so normal was the fact that exceptionally high interest rates were factored into those annuities.

To earn these promised high returns, the insurers channelled an increasing share of their funds into what were believed to be high, sure-fire, yields — real estate, mortgages backed by sagging commercial real estate values and junk bonds. As the stupendous jump in asset figures shows, piles of money poured into the insurance companies.

Just how big is the insurance problem? No one knows. As of year-end 1990, life insurers had \$85 billion invested in junk bonds against \$109 billion in capital surplus and investment reserves. Even more worrisome are an additional \$160 billion in near-junk triple-B bonds. And last but not least, add to these figures another \$260 billion in commercial real estate. Non-performing mortgages — those that are 90 days overdue, in the process of foreclosure or already foreclosed during the calendar year — have surged by 70% to \$11.4 billion in 1990 from \$6.7 billion a year earlier. Worrisomely, 31 insurance companies had over 50 cents in non-performing loans per dollar of capital and surplus.

Looking at the dozens of insurance companies with high-risk exposure, the situation seems ripe for more runs ahead. Worst of all, perhaps, is that the insurance carriers (and, therefore, policy holders) are not backed by the safety net of federal deposit insurance the way thrifts and banks are. That makes the insurers far more prone to a panic run by their policyholders.

But even if a panic can be prevented, insurers are forced to cut their new investments drastically, thus contributing to a deepening and lengthening recession. In fact, they have been doing just that since last autumn. Since then, mortgages and bond investments have only increased at an annual rate of about \$50 billion as compared with the roughly \$100-billion pace of past years.

WHO WILL FINANCE THE RECOVERY?

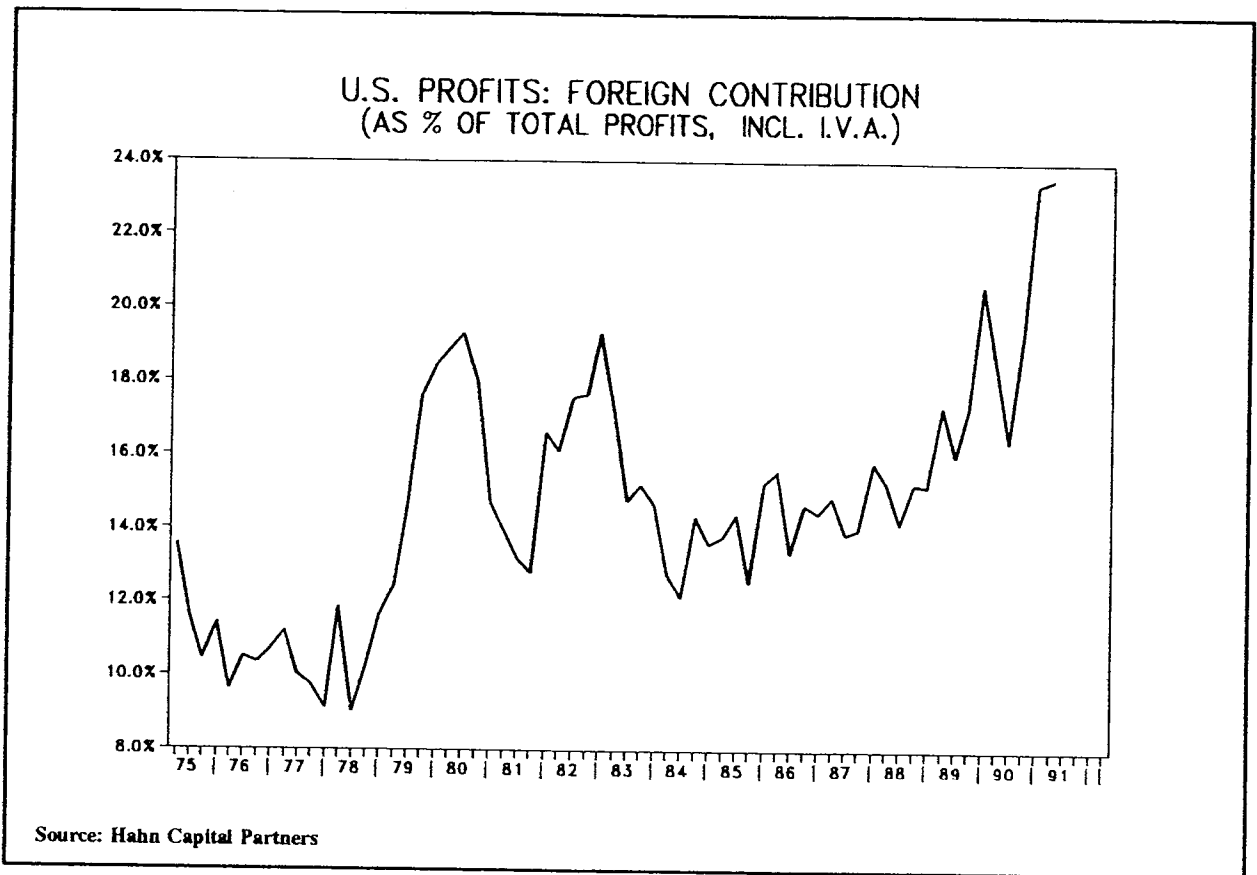
All taken together the fact is this: What amounted to an expansion of about \$400 billion or more on an annual basis in the loans and securities of the commercial banks, S&L's and life insurance companies over recent years has now turned into a sharp contraction.

To all those who still belittle the plunging money supply numbers as being more or less irrelevant for the broader economy, we ask, "Where is the money for the recovery going to come from?" We can only recommend that they analyze the credit-side of the monetary aggregates and the crippled state of the various financial institutions. This is a comprehensive credit crisis . . . a crisis which so far has shown no evidence of bottoming much less stabilizing. Apparently, the storm is still gathering force. Taking into account rising interest payments and inflation-adjustment, there's little doubt about it: this is a massive credit contraction.

American financial institutions are unable to expand their loan portfolios because they are in the grip of a progressive capital erosion due to the disastrously declining values of the main collateral of the financial system — real estate. All this gets us to the greatest potential for danger: a deepening recession precipitating and bringing the real-estate crisis to a head.

A PROFIT RECESSION OF MANY DIMENSIONS

Some people have called this U.S. recession a "balance sheet recession", meaning that it is caused by illiquid balance sheets. Contrarily, others flatly discard the sharp rise of debt levels over the past as a non-issue. What if both camps are wrong? Debts only become onerous over time when underlying profits and incomes decline and new borrowing falls short of interest payments. This recession is due to all sorts of causes but surely the lack of profits is playing a highly-important, if not the ultimate, role.



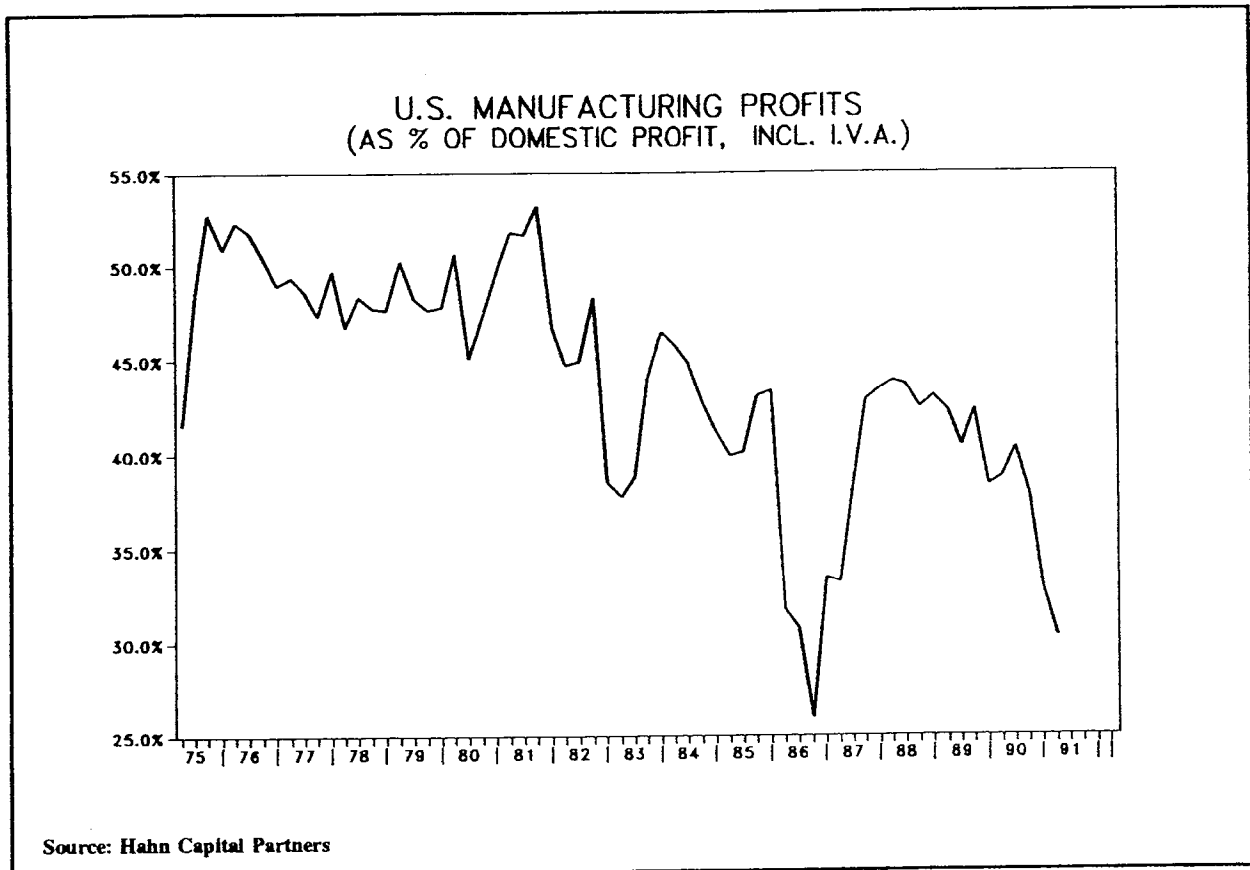
An important agent in the U.S. economy's sudden slide into recession was a sharp downturn in consumer spending. No doubt, the impact of cutbacks in borrowing and lending was a factor in slowing consumer spending, yet its most unusual cause was the pinch on real disposable consumer incomes due to drastic and prolonged labour-shedding by businesses.

Why this ferocious labour-cutting? Answer: miserable profits. The fact is that U.S. corporations are caught in a vicious long-running profit squeeze. Clearly, this profit squeeze that's strangling the U.S. economy is not merely of cyclical variety. It's a structural and long-term erosion that didn't just emerge with the economic downturn that commenced last summer. The profit decline only accelerated.

A VICTIM OF LOW PROFITS: CONSUMER SPENDING

This recession was led by sharply declining consumer spending mainly because employment and wages fell, but the two fell because corporations slashed them under the pressure of collapsing profit margins. To quote Keynes: *"Activity of production depends on the business man hoping for a reasonable profit. The margin which he requires as his necessary incentive to produce, may be a very small percentage of the total value of product. But take this away from him and the whole process stops."*

In order to understand the deep-seated malaise of the U.S. economy, one has to look at the profit trends. Since 1980 — also a recession year, by the way — the share of business profits in U.S. national income has tumbled from 9.4% to 6.5% recently. That's bad enough, but the true picture is



much worse because the profit figures of the 1980s have been strongly embellished by the soaring profits pocketed by U.S. companies abroad. While profits abroad have more than trebled from a level of about \$20 billion in the early 1980s to \$68 billion recently, domestically-earned profits of non-financial corporations have only increased by about 40%. (Please see chart on previous page).

As miserable as this domestic earnings picture is, it's sobering to realize that even these profits have been heavily inflated by the long stock market boom of the 1980s. How did that happen? Through the pension funds. During the 1970s, corporations had to make heavy contributions from current earnings to meet the funding requirements of their pension funds. During the 1980s, by contrast, pension plans were adequately funded and in many cases over-funded by the soaring securities markets. As a result, corporations were spared contributions from earnings and in that way boosted their recorded profits.

Obviously, this mechanism also works in reverse whenever the big capital gains in the stock markets cease, or even worse, when the market declines. Such an occurrence, in turn, forces cash-strapped corporations to kick in additional contributions. Anytime the pension funds suffer a down year, corporations must make up the difference. The rules, though, allow under-funding.

However, there is yet another ominous trend in the development of U.S. profits. That's the sharply declining share of domestic profits by manufacturers. (Please see chart above).

PROFIT DECLINE CENTRES ON MANUFACTURERS

It is one of the many Wall Street myths that foreign capital is drawn into the United States by unusually high levels of profitability. It's clear that many foreign businessmen have been taken in by this perception. It's a mockery of reality. Since the beginning of 1987, foreigners have added more than \$200 billion to their direct investments in the United States. Yet, reported income payments on all direct investments of foreigners in the United States are lower today than they were in 1987. America has become the graveyard of European and Japanese capital.

More ironically, an important reason why the U.S. current account has improved during this period is that foreigners are logging more losses than profits on their huge investments in the United States while income receipts on the direct investments of U.S. companies abroad are soaring.

It was the corporate sector's profit squeeze and the ensuing labour-shedding that drove the U.S. economy into recession. Conversely, any potential for a recovery crucially depends on the health and strength of corporations. They are the key, not the consumer. It is difficult to foresee a sustained rise in consumer spending without a strong recovery in employment and real incomes.

Wall Street's cheerful rationale for the bullish stock market is that the necessary rise in real incomes will come through falling inflation. That, too, is another one of those grossly-flawed, simplistic equations with which Wall Street deceives itself and others. Why? Because the argument ignores profits. It makes a big difference whether a country sports low inflation with high corporate profits or low inflation with vanishing profits.

Surveying the evidence in this respect, we note that any fall in the inflation rate of the Anglo-Saxon countries (United States, Britain and Canada) has been coming out of the hides of business profits. Domestic profits of U.S. manufacturing corporations have dropped to a level of \$67 billion, following \$106 billion in 1988. That's a tremendous plunge and leaves profits little above their previous low in the deep recession of 1982 (\$56 billion). As a share of national income, U.S. manufacturing domestic profits have plummeted to an absolute low of 1.5%, against 2.2% in 1982.

CONCLUSIONS

When the U.S. money supply suddenly spurted in February and March of this year after a prolonged weakness, it was immediately cited as a conclusive signal of an economic recovery. Just as soon as the money supply figures waned again, however, interest in the importance of money supply faded just as quickly. Market participants and the Fed comforted themselves with easy-going explanations. Instead, it was increasingly emphasized that a healthy recovery was assured by the sharp reduction in the federal funds rate which was engineered by the Fed between October and April.

Such equanimity, though, is becoming questionable given dramatically worsening money figures. Since the end of December 1990, the Fed's favourite target, M2 has risen at an annual rate of 2.2%, and since March-end by a mere 1%.

For several years now money growth has been slowing. The export boom of 1987 to 1989 served to temporarily decouple the economy from money growth. Now that the export boom is over, the still-

deteriorating monetary picture comes into the foreground.

Is there any plausible reason why this is happening even as almost everybody foresees an economic recovery? The obvious reason is a spreading, self-reinforcing credit crunch. Credit tightening has spread from the S&L's, to the commercial banks, and now further to the insurance companies. There isn't one remaining sector in the U.S. economy that has the financial power to help finance a sustained recovery. That's a fundamental fact that foreshadows a deepening recession.

A deepening U.S. recession will claim two main victims: the U.S. stock market and the U.S. dollar. Both can be expected to plunge. The magnitude of the dollar's prior rally suggests the markets were counting on a robust recovery in the U.S. economy to be financed by an accelerating inflow of foreign capital.

So far, the recent weakening in the U.S. dollar only reflects a gradual downward adjustment of recovery expectations to a more lacklustre variety. By and large, gauging from stock market trends and financial market ratios such as the TED-spread, complacency remains enormously high. Financial markets remain unruffled despite heightening risks.

A deepening U.S. recession, as we expect though, will compel a desperate Fed to an even greater monetary easing. Such a move would be sure to pull out the rug from underneath the dollar.



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